The New Mexican Industrial Development Plan

Mexico is just beginning to reap a tremendous oil harvest. It is now reaching its ceiling production level of 2-1/4 million barrels of oil a day, which level had earlier not been expected to be attained until 1983.[1] Mexico is exporting approximately half its production and is obtaining OPEC prices for these exports. At these rates, Mexico should receive well over $10 billion (U.S.) in oil export revenues in 1980.[2]

These figures represent a significant turning point for Mexico as viewed from outside and inside of Mexico. For Americans, it is truly shocking to find, after all these years, that we may have grabbed the wrong half of Mexico. For Mexicans, these new circumstances present a unique opportunity to attack serious problems. The Mexican government appears determined to properly manage this opportunity.

The keystone in the government's plan to manage the oil wealth for progress in Mexico is the National Industrial Development Plan which was enacted last year. This plan formulates industrial policy for Mexico for the short range, through 1982, and for the long range, through 1990. It arose out of both the opportunity presented by the oil reserves and the emergency presented by Mexico's deepening economic problems.[3]

Mexico's greatest economic problem is unemployment.[4] Mexico's high birth rate has given the nation a present population of approximately 70 million people. The demographic trend has been for the growing excess population from the countryside to pour into the cities and live on a static volume of domestic food production.[5] The overpopulation of the cities has caused serious urban problems of crowding, pollution and unemployment. Mexico City now has about 8.8 million residents and perhaps many more who have not been counted.

The cities of Mexico City, Guadalajara and Monterrey house the overwhelming majority of Mexico's present industrial capacity. The industrial base is characterized by a small number of large oligopolies and an enormous

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[1]World Bus. Weekly, Feb. 25, 1980, at 29.

[2]*Id.*

[3]*Introduction,* I Secretaria de Patrimonio y Fomento Industrial, Industrial Development Plan, 1979-1982-1990 (1979), [hereinafter cited as Development Plan, with citations to Volume and Chapter numbers to enable reference to both the original Spanish-language version and the abridged, English-language version. Page citations will be to the English-Language version.] The Development Plan forms a part of a Global Development Plan released in Spring 1980, which constitutes a comprehensive, long range plan for many sectors of the Mexican economy and society.

[4]The Economist, August 13, 1977, at 60.

[5]*Survey,* The Economist, April 22, 1978, at 30.

number of small companies of marginal productivity and profitability. Historically, imports have exceeded exports in Mexico, and this balance of payments problem played a key role in the weakening and eventual devaluation of the peso in 1976.[6] Even after the devaluation, inflation continued to be a serious Mexican problem and, except for the recent surge in the United States' inflation, has been running at about double the United States' rate.[7]

In analyzing these problems, Mexican economists place no small measure of blame on the "import substitution" policy followed by the Mexican government since the 1940s. As was generally well known to potential foreign investors, this policy used a system of import permits to encourage foreign companies to construct plants in Mexico rather than importing from abroad to serve the Mexican market. One could make arrangements with the Mexican government for construction on the condition that competitors not be allowed to import into Mexico. In some cases, this did reduce imports, but its impact on the balance of payments was insufficient because it did not encourage exports. In fact, it often actually increased imports by permitting the importation of machinery and subassemblies to the protected factories.[8] Most importantly, the resulting industry was tailored principally to satisfy Mexican consumer needs with no concern for the utilization of Mexican raw materials or labor for the world market. As a consequence, industry concentrated in the cities where the consumer demand existed and avoided the areas with easy access to raw material resources or export transportation.

The National Industrial Development Plan of 1979 intends to treat these problems by de-emphasizing the import substitution policy and more thoroughly guiding the economy toward specific goals with a combination of tax incentives and favorable energy rates. The plan also mentions low interest loans, new sources of capital and a coordinated government procurement policy as potential lures for investors.[9] With these devices the Mexican government expects to greatly increase investment in and development of a less concentrated economy which is more geographically dispersed, particularly to areas along the borders and near ports.

The plan calls for significantly improved productivity, particularly with a view toward the world marketplace. It is Mexico's policy to export no more than half of its oil, leaving the remainder to meet its own energy needs and to create a secondary petrochemical industry.[10] Following these policies, Mexico plans an annual gross national product increase of about 10 percent per year from 1982 through 1990.[11]

To be specific, the plan sets investment priorities among industrial activities. Particularly high priorities are given to investments in the capital goods

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[6] *Id.* at 17.

[7] 3 INVESTING, LICENSING & TRADING CONDITIONS ABROAD (Mexico) 3 (May, 1980).

[8] I DEVELOPMENT PLAN, ch. I at 9.

[9] *Id.* at 15 and *id.*, ch. IV at 58.

[10] WORLD BUS. WEEKLY, Feb. 25, 1980, at 32.

[11] I DEVELOPMENT PLAN, ch. I, at 18.

manufacturing and food processing industries.[12] For instance, the plan contemplates a short range enhancement for investment in the manufacture of electric machinery that is 148 percent of the investment level without the Plan.[13] Similarly, investment increases of 104 percent in the manufacture of metal products and of 118 percent in the production and processing of meat and milk products are expected to be implemented under the plan.[14] To encourage industries to decentralize, the plan gives priority to investment in certain geographic regions.[15] Zone One, which offers the highest incentives, includes new industrial ports, a number of coastal and border areas and areas served by natural gas pipelines, including the new 48-inch gaslines.[16] Zone Two, with somewhat lower incentives, includes areas selected by the individual states for industrial activities.[17] Zone Three, comprised primarily of Mexico City, is segregated in order to discourage, rather than to encourage further industrial development.[18]

By combining the priorities attached to the nature and location of a proposed investment project, one can determine the level of incentive to be offered for the development. The highest priority activities carried out in the highest priority locations will obtain a 30 percent discount on natural gas, fuel oil, electricity or other energy rates (which are already somewhat lower in Mexico than on the international market), and a 20-25 percent of fixed asset value investment tax credit.[19] The level of the tax credit will depend on whether the taxpayer is a "small business," *i.e.*, a company with fixed assets of about $440,000 (U.S.) or less.[20] Investments with less than top priority receive lower energy discounts and tax incentives.

In general, Mexico's practice of using import permits to close its trade border will be replaced by a tariff structure[21] in which, presumably, some protectionist flavor will remain.

Mexico will continue its in-bond program for assembly plants,[22] under which a foreigner may own 100 percent of a plant in Mexico; ship parts to the plant from his home country free of Mexican duty; assemble the parts in Mexico; employ Mexican labor and ship the finished product back to his home country.[23] Assuming the home country is the United States, American

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[12]*Id.*, ch. III, at 38-40.
[13]*Id.*, ch. I, at 27.
[14]*Id.*
[15]*Id.* ch. III, at 45-52.
[16]*Id.* ch. I, at 13.
[17]*Id.; id.*, ch. III at 45.
[18]*Id.* Ch. I, at 13; *id.*, ch. III, at 51.
[19]*Id.* ch. IV, at 54-57.
[20]A "small business" is one with total fixed assets, including those of affiliated companies, that do not exceed 200 times the annual minimum wage in the Federal District. 3 INVESTING, LICENSING & TRADING CONDITIONS ABROAD (Mexico) 25 (1979).
[21]I DEVELOPMENT PLAN, ch. IV, at 58.
[22]*Id.* at 57.
[23]3 INVESTING, LICENSING & TRADE CONDITIONS ABROAD (Mexico) 4 (May 1980).

duties apply only on the value added to the product at the in-bond plant in Mexico.[24]

In-bond assembly plants also may sell a small portion of their finished product in Mexico by paying Mexican duty only on that portion.[25] They benefit in some circumstances from stamp tax waivers in leases and from import duty waivers on machinery and equipment.[26] Because the in-bond progam already is successfully stimulating considerable activity, such foreign-controlled plants will receive no additional benefits under the new incentive program.[27]

However, for Mexicanized companies outside the in-bond program which employ people, produce capital goods, help solve the food shortage, increase Mexican exports and/or locate in the newly designated industrial centers, there is now a tax credit and energy saving incentive package. Further, the plan alludes to low interest loans and other aids.

In concluding that such development activities should be encouraged, the development plan embodies a sophisticated appraisal of Mexico's problems, of their origins and of the types of investments that are needed to attack the problems. In seeking to avoid excessive exporting of Mexico's crude oil, the Development Plan has provided an intelligent guide to the appropriate management of Mexico's oil wealth.

Implementation

Unfortunately, the plan does not provide for the actions necessary to implement its terms. For whatever reasons, political or otherwise, the incentives offered are likely to be seen by potential foreign investors as very meager fare in view of the continuing difficulties of investing in Mexico.

First, neither of the incentives discussed here[28] is intended to be available in the long term. The energy cost saving is not expected to be offered after 1989,[29] and in any event, a 30 percent discount is stingy in view of Mexico's resources and its intention to raise its base domestic price to near-OPEC levels. The tax saving occurs as a one-time investment tax credit, rather than as a tax holiday like that offered in other countries' incentive programs.[30] In

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[24] *Id.*

[25] *Id.*

[26] *Id.* at 30.

[27] I DEVELOPMENT PLAN, ch. IV, at 57.

[28] The other incentives mentioned in the DEVELOPMENT PLAN, such as new sources of capital, low interest loans, government procurement programs and new tariff policies are, in fact, just mentioned briefly in the Plan. Only the tax and energy rate incentives are treated with sufficient specificity in the DEVELOPMENT PLAN for their potential impact to be considered in this discussion.

At this point, one can only say that without more specific definition, the other incentive "tools" of the DEVELOPMENT PLAN are unlikely to influence the investment decisions of foreign investors.

[29] *Id.*, ch. I, at 15.

[30] *E.g.* Saudi Arabia and Ireland.

addition, the benefit of a tax credit often is neutralized for United States investors by the United States foreign tax credit system. Outright grants and subsidies, features of programs in some other countries, are totally lacking in Mexico. The foreign investor also remains entrapped in the requirements of the Law for the Promotion of Mexican Investment and Regulation of Foreign Investment[31] and the Law on Transfer of Technology and Use and Exploitation of Patents and Trademarks.[32] Both laws took effect in 1973. These restrictions apply to foreign investors, regardless of their involvement with the incentive program, and in fact, applicants for incentives may face more stringent requirements.

The transfer of technology law requires that all transfer of technology agreements be registered with and approved by the National Registry of Technology Transfer. Such agreements include license agreements, management agreements and training and technical services agreements which are so often a key part of any investment by a United States company in the developing world. In its approval procedure and in international forums on the subject, such as the United National Conference on Trade and Development (UNCTAD), Mexico has been an outspoken leader of the Third World. Mexico is aggressive about rejecting and rewriting contract terms agreeable to both parties and otherwise acceptable in international business, *e.g.*, royalty rates above 3-5 percent, grant-back clauses for new developments, export limitations and terms for more than ten years.[33] While this surely counteracts some genuine abuses, it also effectively discourages needed technology transfer and related investment.

The substance of the Law for the Regulation of Foreign Investment can be summarized as follows: All foreign investments in Mexico must be registered with and approved by the National Commission on Foreign Investment and, except for special circumstances, foreigners cannot purchase more than 25 percent of the stock or 49 percent of the assets of an existing Mexican company. Also, foreigners may not hold more than 49 percent, or actual management control, of any new Mexican ventures.[34] Further, under this law, foreign participation is limited to 40 percent in the secondary petrochemical industry and in the production of automobile parts, and is prohibited in a number of activities, *e.g.* petroleum and hydrocarbon production, basic petrochemical and certain mining activities, railroads, air and highway transportation, radio and television, and a few others.[35]

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[31] *Diario Oficial,* March 9, 1973 [hereinafter cited as D. O.]. For an English translation, see 12 INT'L LEGAL MATS 421 (1973).

[32] Hyde & Ramirez de la Corte, *Mexico's New Transfer of Technology and Foreign Investment Laws—To What Extent Have the Rules Changed?* 10 THE INT'L LAW. 231, 235-38 (1976).

[33] *Id.* at 239-250.

[34] *Id.* at 239-250.

[35] *Id.* at 240 n.22.

To obtain permission to invest in permitted activities is not difficult so long as the foreigner invests no more than the permitted percentage and does not control management. The commission historically rejects only a small percentage of proposed investments within those guidelines.[36]

Also, although it occurs seldom, significantly more than 49 percent participation may be allowed if a proposed project meets most or all of Mexico's development needs, by offering such features as high employment, high exports, a favorable location and a significant technology transfer to Mexico. Texas Instruments, for example, recently obtained approval for 100 percent ownership of a $60 million investment in Mexican plants involving considerable high technology transfer and production of goods, 80 percent of which will be destined for the export market.[37] However, it is often the case that majority ownership is permitted on the condition that the firm be "Mexicanized" to at least 51 percent Mexican ownership over a period of several years.[38]

On their face, the above investment restrictions do not appear to be particularly draconian. They are enforced with some flexibility and do lack some severe features that exist in similar laws elsewhere in the developing world. For instance, unlike Brazil, Mexico has no exchange controls, allows technology transfer to be considered part of an equity investment and allows subsidiaries to pay royalties to their parents.[39] To complete the picture, though, one must note that while some progress is said to have been made, Mexico remains notorious for bureaucratic inefficiency, and corruption is a problem in certain sectors.

The overall picture, then, is of a regulatory scheme which in most instances, freely allows investment subject only to a limited return on invested technology and the minority ownership restriction. However, as practical managers know, those small restrictions can be very meaningful.

In particular, the minority ownership rule essentially requires a great deal of trust between the foreign investor and the local majority owners. A carefully drafted joint venture agreement can give a measure of protection, particularly in provisions for dispute settlements and liquidations. Still, there is no substitute for trust based on a thorough knowledge of the particular local participants and a carefully nurtured, harmonious relationship.

The key to the latter is the formulation of a business plan, the economic success of which is substantial and assured, by a very comfortable projected rate of return. While this may appear obvious, consider the United States Department of Commerce figures which indicate that in 1977, an ordinary

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[36] 3 Investing, Licensing & Trade Conditions Abroad (Mexico) 7 (1979).

[37] Address by Lic. Hector Alvarez de la Cadena, Director General, Foreign Investment and Technology Transfer, Secretaria de Patrimonio y Fomento Industrial, in Los Angeles, California (Jan. 17, 1980).

[38] 3 Investing, Licensing & Trade Conditions Abroad (Mexico) 9 (1979).

[39] *Id. See generally* J.T. Alves de Araujo, Investments in Brazil (4th ed. 1979).

year, United States firms earned an overall 9.2 percent rate of return on Mexican investments. Such a rate of return alone probably will not assure harmony or justify a risky investment.

To avoid the minority ownership problem, the investor must appeal to the Foreign Investment Commission and assert that he meets the same sort of criteria as those for the incentives in the Development Plan. Unfortunately, according to the terms of the Development Plan, if the investor succeeds in gaining majority ownership, he is disqualified from the Development Plan's incentive scheme. If that is, in fact, the way the incentives are enforced, in practice they are likely to be seen as little incentive indeed.

To suffer minority ownership in exchange for the Plan's tax credits and energy rate reductions would appear attractive only to the most energy-intensive operations. Even then, they would be attractive only where suitable arrangements between foreign minority and Mexican majority investors could be made. This type of investment in Mexico would probably be attracted to Mexico's oil economy even without the new Development Plan incentives.

To attract a variety of balanced industrial development while rigidly enforcing the minority ownership rules, the incentive scheme would have to be much more generous—sufficiently generous to create the expectations of profit levels at which potential disputes with majority partners are less likely or at least are a less important factor in the investment decision.

Although this is a somewhat pessimistic view of the prospects for the incentive scheme of the Development Plan to meet the ambitious goals of the Plan, a more optimistic and perhaps more important aspect of the Plan exists. The Plan reflects a new attitude toward encouraging foreign investment which, in Mexico's case, generally has meant investment from the United States.

The laws of 1973 reflect the economic nationalism that has governed Mexican policy in varying intensities for many decades. Those laws, and other anti-foreigner laws such as the 1976 Law of Inventions and Trademarks,[40] which require foreign trademarks to be linked with new Mexican marks, will not disappear from the books. However, this new realization of the critical need for Mexico to participate in the world market and in the United States market through exports will determine how those laws are enforced.

It remains to be seen whether foreign investors will gamble on the permanence of this attitude. To adhere to the Development Plan, as written, in the face of inflationary pressures and the great temptation to make an easy peso by the export of crude oil will be difficult enough. It may be too much to hope that Mexico will go beyond the Development Plan and expand its incentives to actually encourage investment.

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[40]D. O., February 10, 1976.